

THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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CORPORATE GOVERNANCE ALLIANCE DIGEST: SPECIAL IN-DEPTH EDITION ON NEW U.S. SEC "PROXY DISCLOSURE ENHANCEMENTS"

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The New U.S. SEC "Proxy Enhancement Rules" by Eleanor Bloxham

Many boards are asking what the proxy disclosure enhancements approved by the US SEC require, what questions they should be asking, and what issues they should be addressing now. Our international readers may be interested in the questions that the new proxy rules raise for boards and investors.

The new "proxy disclosure enhancements" approved by the SEC are effective February 28, 2010. (For the timing nuances, see <http://www.sec.gov/divisions/corpfin/guidance/pdetinterp.htm>.) Whether the

enhancements to proxy disclosure have a beneficial impact will depend on (1) the way issuers respond to the requirements (2) the SEC's actions in terms of enforcement and (3) investor or other stakeholder reactions.

- What are the requirements?
- What questions may directors want to address with respect to the disclosure?
- What questions may directors hear from investors and others?

The requirements include five major components.

Requirement One: Disclosures about compensation risk.

This new disclosure requirement is a new item, 402 (s) in the proxy -- not part of the CD&A.

When is the new disclosure required?

The new disclosure requires a company to address "its compensation policies and practices for all employees":

- If the company currently completes the CD&A and if their compensation policies and practices create "risks that are reasonably likely to have a material adverse effect on the company" (using the MD&A standard).

The rule is not intended to either specify or be complete regarding examples where this may apply. Emphasizing that this is a non-exclusive list, the SEC believes "situations that potentially could trigger" the need to disclose, include (but are not limited to), compensation policies and practices:

- *Where there is a significant difference in the time horizon for the award compared to the time required for the income or risk to fully manifest* (example: awards made based upon

accomplishment of a task, but "the income and risk extend over a significantly longer period of time")

- At a business unit:
 - That carries a *significant portion* of the company's *risk* profile
 - Where compensation is *structured significantly differently* than elsewhere in the company
 - That is *more profitable* than other units in the company
 - Where *compensation expense is a significant percentage* of the unit's revenues

What should be addressed?

The rule is not intended to specify or be complete, but "examples of the issues companies may need to address regarding their compensation policies and practices include the following":

- *General design philosophy*: the general design philosophy of compensation policies and practices, as they affect risk taking, for the employees whose behavior would be most affected by the incentives
- *The manner of implementation*: The manner of implementation of compensation policies and practices, as they affect risk taking, for the employees whose behavior would be most affected by the incentives
- *What is considered in structuring, awarding and paying*: The company's risk assessment and incentive considerations in structuring compensation policies and practices -- and in awarding and paying
- *Relationship to the realization of risks*: Policies related to claw backs and holding periods -- as well as other compensation policies and practices and their relationship to short term and long term employee actions and risk taking

- *Changes*: How compensation policies and practices are adjusted to reflect changes in the company's risk profile (i.e. company policies related to such adjustments) and *material adjustments the company has made as a result of changes in its risk profile*
- *Monitoring practices*: How (to what extent) the company monitors its compensation policies and practices to determine whether they support/meet risk management objectives

"We would not expect to see generic or boilerplate disclosure that the incentives are designed to have a positive effect, or that compensation levels may not be sufficient to attract or retain employees..."

In sum, to adhere to the new rule *requires* disclosure as outlined above. The disclosure is to be customized to the company's circumstance. If no disclosure is made, the rule does not require the issuer to affirmatively state the assumption of the reader i.e. that the compensation policies and practices *for all employees* do not create "risks that are reasonably likely to have a material adverse effect on the company".

An important footnote in this section states: "to the extent that risks considerations are a material aspect of the company's compensation policies or decisions for named executive officers, the company is required to discuss them as part of its CD&A under the current rules". Note that this requirement is different than that of the new rule. This disclosure is *not* required if risk considerations are not a material aspect of the company's compensation policies or decisions for named executive officers; otherwise, discussion in the CD&A is expected.

Questions to ask and answer:

1. For named executive officers, is risk a material aspect of the considerations regarding compensation policies or decisions for named executive officers at this firm?
 - ✓ If yes:
 - Have these been properly disclosed per the footnote requirements? How? What do we need to say now?

- Countrywide took risk into account when making their compensation policies or decisions and disclosed this. In light of the crisis, as directors, are we sufficiently considering risk in our compensation policies and decisions? Is this an area we cover in our board evaluation? As investors, risk may be considered but is it sufficient? Can we tell from the disclosure? Do we even know how to judge this?

✓ If risk is not a material aspect of consideration, why not?

- As directors, is risk an area we cover in our board evaluation? Is risk a material aspect of considerations of other strategies and strategic decision making? If so, is risk a material aspect of the considerations related to what we hold named executives officers accountable for? If not, why not?
- "The main challenge for asset managers in the coming decade is understanding, managing and communicating risk." (FT, "Managing risk is the main task ahead", Grene, 1/3/10) As investors, is investment in a firm where risk is not a material aspect of compensation policies or decisions for named executive officers prudent? If we invest, do we thoroughly understand the risk we are taking on?

2. Which employees, if any, individually or as a group, are *not* in a position to create "risks that are reasonably likely to have a material adverse effect on the company"?

✓ As directors, do we know? How? What could change the current scenario and create a different answer for those employees?

✓ As investors, what employees might fall into this situation given the activities of this firm?

3. What specific risks do our employees have influence over?

✓ As directors, what's our process for getting to this understanding? When we develop the MD&A, does our corporate disclosure process start with understanding the risks under

employee control (as well as other risks) and then clearly walk us to those that are reasonably likely to have a material adverse effect? Did the recent crisis expose some gaps? Does our board evaluation process cover the sufficiency of our understanding and of our disclosures?

✓ As investors, does the corporate disclosure in the MD&A seem to provide a clear outline of activities under board, management and employee control which are reasonably likely to produce risks that could have a material adverse effect?

4. How do our incentive programs incent? What are the specific metrics used? What is the form of pay? What is the timeframe for payouts?

✓ As directors, what will the incentive program cause management and employees to focus on? What will the metrics cause management and employees to focus on? What will the form of pay cause management and employees to focus on? What will the timeframe do to change the focus? Are these areas of focus items that management and employees can control? If not, why not and why do we choose to have management and employees focus on them? In the literature, do these areas of focus tend to increase or decrease adverse risk taking and beneficial risk taking? How/why?

✓ As investors, what would ideally align management and employees with what they can control and have responsibility for managing? How do metrics, form of pay, and timeframe increase or decrease adverse risk taking and beneficial risk taking?

5. How do our incentives lessen/ameliorate or increase the probability of occurrence or severity of impact of risks (a) employees have direct influence over (b) other risks (reputational, etc.)?

✓ As directors, if risk is not a material aspect of our considerations for named officers, how do we get to this understanding of how our incentives lessen/ameliorate or

increase the probability or impact of the risks for our named executives?

✓ As directors, what's our process for getting to this understanding for all employees?

✓ As investors, given the job functions and duties within the organization, and the activities which could generate risks reasonably likely to produce a material adverse effect, what compensation programs could be in place to lessen these? What disclosure has the company provided regarding this? What compensation programs could worsen these risks? What disclosure has the company provided regarding this?

6. What other information, if any, should be considered for disclosure to meet the spirit of investor comments although they aren't specifically required under the new rules?

Requirement Two: Changes to Stock and Option Award Value Calculations.

What does this requirement change and which tables does it apply to?

• *Aggregate grant date value of awards for non-performance stock and option awards:*

○ A revision to calculations in the Summary Compensation Table and the Director Compensation Table for non performance stock and option awards.

○ Replace disclosure of the dollar amount recognized for financial reporting purposes for the fiscal year with the aggregate grant date fair value of awards computed in accordance with FASB ASC Topic 718. (See specific instructions.)

• *Aggregate grant date value of performance awards for stock and option awards based on probable outcome:*

○ A revision for performance awards reported in the Summary Compensation Table, Grants of Plan-Based Awards and the Director Compensation Table.

○ Compute the awards based on the probable outcome of the performance conditions as of the grant date.

○ The Summary Compensation Table and the Director Compensation Table should be footnoted with the maximum value assuming the highest level of performance conditions is probable.

○ See specific instructions. For probable outcome calculation: "the amount will be consistent with the grant date estimate of compensation cost to be recognized over the service period, excluding the effect of forfeitures."

• *Awards disclosed will continue to be based on timing of grant with supplemental information as needed :*

○ While awards granted after the fiscal year end are disclosed in the year granted, "supplemental tabular disclosure where it facilitates understanding the CD&A" should be considered.

How will the transition work?

• *Companies with fiscal year end on or after December 20, 2009:*

○ Recompute disclosure on the new basis for each preceding fiscal year as well as the new reporting year.

○ Recompute performance basis on the new methodology for previous fiscal years also.

○ For persons who are "a named executive officer for 2009 but not for 2008", smaller reporting companies (i.e. those "required to provide disclosure only for the two most recent fiscal years") may "provide Summary Compensation Table disclosure only for 2009".

○ Other companies are not required to include new "named executive officers for any preceding fiscal year based on recomputing total compensation for those years" but "if a person who would be a named executive officer for the most recent fiscal year (2009) also was disclosed as a named executive officer for 2007, but not for 2008, the named executive's compensation for each of those three fiscal years must be reported" on the new basis.

Questions to ask and answer:

1. How will integrity be ensured in the calculation of "probable" performance

amounts? What internal controls will be in place and how will the board ensure they are working?

2. What other footnotes and supplemental information, if any, should be considered to meet the spirit of investor comments although they aren't specifically required?

Requirement Three: Director and Nominee Disclosure.

What disclosures are required?

• *Annual disclosures:* Required for each director and any nominee even if they are not up for reelection (including those put forth by other proponents which would be included in their proxy solicitation materials), an amendment to Item 401

• *Reasons for decision:* The "reasons for the decision that the person should serve as a director" including the "particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director for the company as of the time that a filing containing this disclosure is made with the Commission", an amendment to Item 401

• *Committee suitability or risk assessment skills:* No specific requirement although if an individual was chosen due to attributes needed for a certain committee or chosen for their risk assessment or other skills, this should be disclosed.

• *All directorships at public companies.* All directorships at public companies and registered investment companies held by each director and nominee at any time during the past five years, an amendment to Item 401.

• *Legal proceedings for a ten year period.* Legal proceedings disclosures for a ten year period, an amendment to Item 401(f), including additional legal proceedings not previously required, to include:

○ "Any disciplinary sanctions or orders imposed by a stock, commodities, or derivatives exchange or other self-regulatory organization"

○ "Any judicial or administrative proceedings":

- “Resulting from involvement in mail or wire fraud or fraud in connection with any business entity”
- “Based on violations of federal or state securities, commodities, banking or insurance laws and regulations, or any settlement to such actions” (but excluding “settlement of a civil proceeding among private parties”
- *Diversity*: Disclosure related to board diversity as an amendment to item 407, including:
 - “Whether and if so how a nominating committee considers diversity in identifying nominees for director”.
 - Diversity to be defined in whatever way the company and board deem appropriate.
 - Disclosure, “if the nominating committee (or the board) has a policy with regard to the consideration of diversity in identifying director nominees”, as to:
 - How this policy is implemented.
 - How the nominating committee (or the board) assesses the effectiveness of its policy.

Questions to ask and answer:

1. What changes would be beneficial to our board succession and nomination processes?
2. How do our current board members’ and nominees’ backgrounds relate to the challenges required to manage our business strategy and its risk as outlined in the MD&A and in our confidential materials?
3. What is our definition of diversity and how have we and how would we like to define it going forward?
4. Are the nominating committee charter and policies up to date and in line with the new requirements? Do we have a regular process/time cycle for appropriate updates?
5. What changes should be made to our board evaluation process to meet the requirements and spirit of the new guidelines?
6. What other information, if any, should be considered for disclosure to meet

the spirit of investor comments although they aren’t specifically required under the new rules?

Requirement Four: Board Leadership Structure and the Board’s Role in Risk Oversight.

What are the disclosure requirements in Item 407 of Regulation S-K and Item 7 of Schedule 14A?

- *Board leadership choices*: Disclosure concerning:
 - “Whether and why it has chosen to combine or separate the principal executive officer and board chairman positions”.
 - “Why the company believes that this board leadership structure is the most appropriate structure for the company at the time of the filing”.
 - If there is a lead independent director, “whether and why” there is one and “the specific role the lead independent director plays in the leadership of the company”.
- *Board’s role in risk oversight*: Disclosure concerning:
 - How the company “perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company”.
 - This may include:
 - “how the board administers its risk oversight function” (i.e. full board, via a committee(s) or a combination)
 - “whether individuals who supervise the day –to-day risk management responsibilities report directly to the board as a whole or to a board committee”
 - “how the board or committee receives information” from them.
 - Applicable to funds as well as corporate issuers and should provide “how a fund perceives the role of its board and the relationship between the board and its advisor in managing material risks facing the fund”

Questions to ask and answer:

1. Is the job description for the CEO up to date?

2. Are the job descriptions for the Chair, Lead Director and any other board leadership positions up to date?
3. Are the governance committee and/or board policies regarding board leadership positions and decision making related to them including procedures for selection up to date? Are they on a regular schedule for review and update? Are they part of the board evaluation process?
4. Do the board’s policies and procedures, committee charters and the board’s job descriptions accurately reflect the board’s oversight of the risk process? Are they on a regular schedule for review and update? Is this reflected in the board evaluation?
5. Is the role of management (or in the cases of funds, the advisors) clearly defined? Are the job descriptions of individuals who supervise the day-to-day risk management responsibilities up to date? What is the board’s role in their evaluations and compensation? Are the policies clear and documented?

Requirement Five: Compensation Consultants

When is disclosure related to compensation consultants not required?

- *When consultants to management only*: When they work only for management and the board has its own consultant.
- *When broad-based/information services only*: When they perform “services involving only broad-based non-discriminatory plans or the provision of information such as” ... non-customized surveys or surveys which “are customized based on parameters that are not developed by the consultant”

When is disclosure related to compensation consultants required?

- *When board consultant and non exec compensation fees > \$120k*: When the board has engaged “its own consultant to provide advice or recommendations” on executive and director compensation and the consultant or its affiliates provide non-executive compensation consulting

services and the fees for the non-executive compensation consulting services exceed \$120k.

- *When no separate consultant engaged by board and non-exec compensation fees > \$120k:* When the board has not engaged its own consultant and a consultant provides executive and non executive compensation consulting services and fees for the non-executive compensation consulting exceed \$120k for the fiscal year.

What disclosure is required in these circumstances?

- *Board consultant and non exec compensation fees > \$120k:*
 - Aggregate fees paid for executive and director compensation consulting
 - Aggregate fees paid for non-executive compensation consulting
 - “Whether the decision to engage the compensation consultant or affiliates for non-executive compensation consulting was made, or recommended, by management and whether the board approved such other services”
- *No separate consultant engaged by board and non-exec compensation fees > \$120k:*
 - Aggregate fees paid for executive and director compensation consulting
 - Aggregate fees paid for non-executive compensation consulting

Questions to ask and answer:

1. Do we have a board policy on the hiring of compensation consultants? Does it specify whether or not they may provide non-executive compensation consulting and the board’s role in approving that?
2. Do our board evaluations adequately address our policies on independence?
3. Are there other disclosures not required by this rule that would be helpful to investors that we would like to address?

Shareholder Voting Results

In addition to these five requirements, the changes also include a new provision

that shareholder voting results are to be reported on Form 8-K (and no longer need be disclosed on Forms 10-Q and 10-K). Because there may be situations where it may take more or less time to finalize the vote counts, instructions “state that companies are required to file the preliminary voting results within four business days after the end of the shareholders’ meeting, and then file an amended report of Form 8-K within four business days after the final voting results are known.” If final results can be supplied within four business days after the end of the shareholders’ meeting, there is no need to file preliminary results.

The new “Proxy Disclosure Enhancements” are complex and present an opportunity to showcase the positive functioning of the board. We are pleased to address your questions more specifically one-on- one or in specific forums. Please write to ebloxham@thevaluealliance.com or phone her at 614-571-7020.